cutting out the noise

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Intelligent investors fulfil opportunities by remaining disciplined throughout market ups and downs, says Graham Bentley.

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" The shortest interval of time measurable by man is between the moment when it's too soon to buy stocks, and the moment when it's too late."

John Manley, Smith Barney

A 70-mile commute into London may not be everyone's ideal start to the day, but that's the downside of living in East Anglia – and I might add, the only one. A hidden advantage of that hour's journey however is the opportunity to read. While many of my fellow passengers skim a variety of quality newspapers or devour the latest chic-lit classic, I have lately been reacquainting myself with an investment bible. In 1934, with David Dodd, Benjamin Graham wrote 'Security Analysis', the book that gave birth to the concept of 'value investing', and turned investment management from what had been an arcane and somewhat medieval practice into a profession. Fifteen years later he turned his attention to the layman, intending to 'supply... guidance in the adoption and execution of an investment policy'. Ben Graham's 'The Intelligent Investor' was published in 1949. Warren Buffet read the book in 1950 when he was nineteen, and in the preface to the 1973 edition describes it as '...by far the best book on investing ever written'*. He still feels that way. We've just had a scary market period and find ourselves in deep recession – Graham worked through the depression years and World War II, through to recovery and beyond. His investors were asking the very same questions – when is the right time to invest?

Consider the UK equity market. Despite the economic outlook being dire (according to economists), over the past 22 weeks the UK has seen rebounds across the board: Hoare Govett Smaller Companies Index (+41%), FTSE® 250 (+ 36%) and FTSE® 100 (+30%). Meanwhile, cash continues to return next to nothing, and gilts have fallen. Corporate bonds have fared well as spreads have narrowed from the excessive positions of late 2008 – the IMA Sterling High Yield sector average has risen some 29%**. Around the world, the story is much the same.

So, why are stock markets going up if the outlook is so poor? What if this is a 'bull trap'? As I demonstrated in May's issue of informer, there is little correlation between the measure of economic performance, Gross Domestic Product (GDP) and stock market performance. In his seminal work on US welfare policy 'Losing Ground', Charles Murray mentions 'average annual growth rate from 1953 to 1959 was 2.7%, noticeably lower than the average annual growth of 3.2% from 1970 to 1979.'^ Despite the US economy's allegedly greater performance in the 1970s versus the 1950s, the S&P 500 rose 255% in the 1950s against 17% in the 1970s.

fulfilling opportunity

So are prices rising currently because investors are discounting recovery? That may be, but for my part I am fortunate enough to be adding to my ISA this year, and I'm fulfilling that opportunity; not because I've made some decision as to the likely date of economic recovery (whatever that means), but thanks to Ben Graham and others. I have a discipline – an asset allocation that suits my goals (living in retirement disgracefully), and topping it up every year. That discipline helps me to take the emotion out of buying decisions by recognising value. In 'The Intelligent Investor', Graham uses the allegory 'Mr. Market'. Imagine you own a $1,000 stake in a business. Every day, one of your partners, Mr. Market, comes to the office and tells you what he thinks your stake is worth, and then offers to either buy your stake in the company or sell you his, whichever you'd prefer. While sometimes his price will seem plausible given what you know about the

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business and its prospects, you also know that Mr. Market is a manic-depressive. While on one of his euphoric highs, his offering price for the business is high as well. His outlook for the company is wonderful, so he is only willing to sell you his stake in the company at a premium. Fortunately for you, he'll pay you that price for your stake if you want to sell. At other times, his mood collapses and all he sees is a dismal future for the company. In fact, he is so concerned, he is willing to sell you his part of the company for far less than it is worth. All the while, the underlying value of the company may not have changed – just Mr. Market's mood. You are of course free to ignore him if you don't like his price. The next day, he'll arrive at your office with a new one. The more extreme his behaviour, the more opportunity you will have to take advantage of him. As long as you have a strong conviction of what the company is really worth, you will be able to look at Mr. Market's offers and calmly reject or accept them. This is exactly how the 'intelligent investor' should consider the stock market. By thinking of share prices in this way – as mere quotes from an emotionally unstable business partner – you are free from the emotional attachment most investors feel towards rising and falling share prices. On this basis, as investors we should welcome falling prices. The only time you want high share prices is when you are eager to sell your funds, or are taking distributions that will have grown on the back of those increases in capital.

what is Mr. Market saying?

Is Stock Market plc a business we want to buy or not? Are Mr. Market's prices plausible, or coming out of a depressive low, or manic? Well, considering his manic phase in 1999 and the depths of his depression in 2003, what is the evidence that can inform us about his current state? I have spoken before about Tobin's Q, and how regression analysis shows there to be a very strong relationship between that ratio and subsequent 10-year returns. The current ratio of 0.64 implies annualised returns of around 11% per annum over the next 10 years on the S&P 500, a market closely correlated to the UK.

Another is cyclically adjusted P/E ratio (CAPE). In boom times when earnings are high the standard P/E measure can appear reasonable while in periods of recession the P/E can seem expensive. Since profits revert to a mean over an economic cycle, it is more rational to smooth the P/E ratio to take account of this cycle and give a fairer picture of value. This is the aim of the CAPE, first mentioned in Ben Graham's work†, and it has proved to be a reasonable indicator of future returns. CAPE averages can be calculated back to 1881 in the US, however in the UK the long-term data on earnings is not reliable and tax changes over the years further complicate its calculation. However, because of the aforementioned correlation, CAPE-based indicators should remain valid for the UK investor. The long-term average of CAPE is about 16. In March, at the recent market low, CAPE reached 11.4, about 14% below the median low level of the last 26 recessions. Again an implied 10-year return of over 12% per annum is indicated.

If your clients have cash, they should be in the market to the extent that their risk-aligned asset allocation allows. Ben Graham's legacy is seen in the extraordinary results of his protégé Warren Buffet, and frankly if it's good enough for them who are we to argue?

*Graham, Benjamin 1973 – 'The Intelligent Investor – A Book of Practical Counsel', Harper Collins.
**Source: All performances, Financial Express Analytics – 9 March 2009 to 29 July 2009.
^Murray, Charles 1984 – 'Losing Ground: American Social Policy 1950-1980', Basicbooks.
†Graham, Benjamin 1934 – 'Security Analysis' – McGraw Hill.
Past performance is not a guide to future performance.

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